KEY POINTS
- The draft Code takes the current law as its starting point and then attempts to simplify and modernise it.
- It covers security over all types of property, including land.
- It does not draw a distinction between fixed and floating charges – and one issue for discussion is therefore what, if any, liabilities should rank ahead of charges on an insolvency.

Feature

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A Secured Transactions Code

The Financial Law Committee of the City of London Law Society has issued a Discussion Draft of a Secured Transactions Code. This article summarises the key points of the Code, the purpose of which is to start a discussion about whether it is desirable to codify the English law of secured transactions and, if it is, how it should be done.

THE BACKGROUND

The Financial Law Committee of the City of London Law Society (CLLS) has been considering the reform of the law of secured transactions for a considerable time. It was heavily involved in the consultations on the Law Commission's proposals in the early years of the millennium, and then on the implementation of the changes to the system for the registration of charges which were introduced into the Companies Act in 2013.

Having spent so many years considering law reform, the CLLS decided that it would make sense to take advantage of the work which had been done and to continue its work by reviewing how the law of secured transactions works in practice and what reforms are needed.

In November 2012, the CLLS issued its first Discussion Paper on Secured Transactions Reform. Its conclusion was that the law generally works well in practice but that there are areas where it should be reformed. (The Discussion Paper is summarised in *Secured Transactions Reform* (2013) 1 JIBFL 6.)

It identified one key area for reform – the distinction which insolvency law requires to be drawn between fixed and floating charges. Further work was done on this, and a second discussion paper was issued on this problem in February 2014. The problem is caused by insolvency law, and it can only be solved by changing insolvency law. Various possible ways of doing so were discussed in the paper.

Although this is the main area in need of reform, the first Discussion Paper identified a number of other areas where reform would be welcome. Secured transactions law generally works well in commercial practice because of basic concepts such as freedom of contract, the availability of the equitable charge and the registration of company charges. But it has developed in a piecemeal way over four hundred years, and it seemed to us that there was merit in standing back from the current law and seeing if it could be simplified and modernised. In particular, we wanted to see if it would be possible to establish a single security interest – based on the charge – in place of the multiplicity of existing security interests. And the only way to test the hypothesis was to see if we could produce a code which achieved these aims.

We decided that we would not get very far by discussing these issues in the abstract. The best way to test something is to draft it. Only once it has been drafted do the real issues become apparent. You have to start somewhere.

The purpose of the Code is therefore to prompt a discussion. Is there merit in producing a Code and, if so, what should it look like?

THE ADVANTAGES OF A CODE

What would be the advantages of a Secured Transactions Code?

One advantage would be that the law on secured transactions could largely be found in one place. It would benefit practitioners dealing with the subject and students learning it; and it would also make it easier for the law to be exported.

The other key advantages of a Code would be that it could clarify the existing law, simplify it and bring it up-to-date. Our law has developed over a four hundred year period and, although it works well in practice, a Code could replace centuries of accretions with a clear and simple system reflecting the practicalities of modern transactions.

There are, of course, dangers in replacing existing law. There is always a concern that any change will wreak unexpected consequences, but that concern can be allayed by proper consultation on the terms of the new Code.

More importantly, it is vital that a new Code should not destroy the flexibility of the current law. A new law cannot only work in the context of current ways of doing things. Commercial practice changes, and commercial law needs to be sufficiently flexible to cope with that. For this reason, the Code needs to be written at a level of principle which will enable it to adapt to changing methods of financing.

The advantages of a Code would seem to outweigh its disadvantages. But the only way to test whether it would really work is to draft one. It is only by seeing what it might look like that we can see whether we like it.

The approach to drafting

This is the approach that has been adopted in drafting the Code:
- The Code would largely replace the existing law. The necessary simplicity would be undermined if it were only to sit alongside the current law.
- It covers security over all types of property, including land. There is no point in having one system for personal property and another for land. That does not reflect the way in which security is taken in practice.
- It covers consensual security interests, not those which arise by operation of law.
- For practical reasons, certain of its provisions deal with outright assignments of receivables, but, as a general rule, outright transactions are not included in the Code. We see no reason to recharacterise transactions which are not security as if they were.
- The Code has been drafted at as broad a level of principle as is practicable in the light of the subject matter. This is both to preserve the flexibility of the current

law, and also to make the law as simple as practicable.

It is for this reason that the Code has not been drafted in the style of a normal statute. We have tried to make it accessible – both to practitioners and to students. If it were to be brought into effect, this could be done by an enabling statute which would deal with repeals, transitional provisions and ancillary matters.

THE CODE

The Code consists of fifty-five sections, divided into ten parts. The rest of this article contains a brief summary of each of these parts, with a few examples of the way in which the Code is drafted. The complete Code and a User Guide are available on the CLLS website.[1]

Cross-border transactions are very important in practice, and it is envisaged that a further part will be added to the Code to deal with conflict of laws issues after consultation on what is both feasible and desirable.

Part 1: What is a charge?

Part 1 contains the power to create a charge and explains what a charge is and how it differs from an outright interest. The first section sets the scene:

(1) **The power to create a charge**

1.1 A chargor can create a charge over its interest in a charged asset in favour of a chargee to secure the performance of a secured obligation.

1.2 These expressions are described in more detail later. In brief:

(a) the chargor can, subject to the limitations described in part 5, be any person;

(b) the chargee can be the creditor to whom the secured obligation is owed or it may be another person (such as a trustee) on behalf of that creditor;

(c) the charged asset can be property of any kind;

(d) the chargee's interest in the charged asset can be any present or future interest in the charged asset which is capable of being transferred or over which a proprietary interest can be created; and

(e) the secured obligation can be any obligation or liability of any kind, and it does not have to be owed by the chargor.

1.3 This Code is concerned with charges created by a chargor. It is not concerned with charges which arise by operation of law.

Section 2.1 explains that a charge is "a proprietary interest in a charged asset which secures the performance of a secured obligation".

Under the current law, intention is the key element in the creation of a charge, and this principle is replicated in the Code:

(3) **Intention**

3.1 The creation of a charge depends on the intention of the chargor.

3.2 In particular, the following matters are determined by the intention of the chargor:

(a) whether a charge exists;

(b) when a charge has been created;

(c) whether a proprietary interest created by the chargor is a charge or an outright proprietary interest;

(d) the identity of the chargee;

(e) the identity and extent of the charged asset; and

(f) the identity and extent of the secured obligation.

3.3 Intention is a matter of substance, not of form.

3.4 Intention is established objectively. The question is: what would a reasonable person consider the intention of the chargor to be, based on what the chargor has written, said and done?

....

3.7 Whether a person has created a charge is therefore decided:

(a) first, by establishing, as a matter of fact, what the objective intention of that person is, based on what it has written, said and done; and

(b) secondly, by determining, as a matter of law, whether that person's intention is to create a proprietary interest in a charged asset to secure the performance of a secured obligation.

The Code applies to secured transactions. It does not apply to transactions which are not secured transactions even if they have the same economic effect. Section 4 explains how a charge is distinguished from an outright interest, and gives some examples to illustrate the principle.

Part 2: Creation and effectiveness

The Code draws a distinction between the creation and the effectiveness of a charge. The reason for this is to deal with a problem which has arisen in relation to registrable charges.

Under the current law, the chargee has twenty-one days within which to register the charge at Companies House, and this creates what has been described as the "twenty-one day invisibility period". This has not created material problems in practice, but the introduction of a Code would enable it to be overcome. The Code therefore draws a distinction between the creation and effectiveness of a charge. A charge is created in the normal way, at which time the personal rights and duties arise between the parties. But, if the charge is registrable, it only becomes effective as a proprietary interest on registration. This eliminates the invisibility period.

The distinction is explained in s 5:

(5) **Creation and effectiveness**

5.1 There is a distinction between a charge:

(a) being created; and

(b) becoming effective.

5.2 Once a charge has been created, all personal obligations which it imposes on the chargor become binding as personal contractual obligations to the extent permitted by the law of contract.

5.3 Once a charge has become effective, the proprietary interest created by the charge over the charged assets comes into effect.

5.4 Until a charge has become effective, it does not create any proprietary interest over the charged assets.

5.5 The distinction is relevant to charges which are registrable at Companies House. They are only effective once they are registered. See part 7.

5.6 All other charges become effective on creation.

The Code explains how and when charges are created and become effective. It eschews formalities, but accepts that other legislation may impose them. In practice, security arrangements are written down, but we have not required this. The reasons are practical, as anyone having to deal in practice with the formal requirements for the creation of guarantees will understand.

The other major change introduced in this part is that it provides that the charge is the only form of security interest which will be available. Mortgages, security assignments, pledges and contractual liens are abolished.

This is not as dramatic as it sounds. The purpose of the Code is to introduce a single security interest which reflects current practice. So, although legal mortgages are abolished, a creditor will be able to take a legal charge over assets which it can currently take a legal mortgage over. And, if a creditor would currently take a pledge, it will now be able to take a possessory charge which will give it broadly the same rights as if it had a pledge.

It would be logically possible to create a new form of charge which would sit alongside the existing security interests. But that would not simplify the law; it would complicate it. If we are to have a code, we have taken the view that it needs to provide for just one type of security interest.

Part 3: Charged assets

Part 3 broadly reflects the existing law on charged assets:

(11) Charged assets in general

11.1 A chargor can create a charge over any interest which it has, or may have in the future, in a charged asset.

11.2 The charged asset can be property of any kind. It does not need to be located in England or governed by English law.

11.3 In this Code, property is, for certain purposes, divided into:

(a) land: which means land and fixtures;

(b) goods: which means any tangible asset which is transferable by delivery, other than fixtures; and

(c) intangibles: which means any property other than land or goods (and some intangibles may constitute financial collateral).

11.4 The interest can be any collection of rights, liberties, powers and immunities which the chargor has in the charged asset if:

(a) it is capable of being transferred or;

(b) a proprietary interest can be created over it.

11.5 The interest does not, therefore, have to amount to ownership. It can be legal or equitable. It can be outright or by way of security.

11.6 The charged asset must be capable of being identified as falling within the scope of the charge when the charge comes to be enforced. It is not necessary to identify it as falling within the scope of the charge at an earlier stage.

An attempt has been made to clarify, and sometimes to improve, some of the more technical aspects of the existing law. So, for instance, s 14 goes further than the current law by setting broad default rules on the extent to which a charge over an asset extends to connected assets.There is a specific section which deals with receivables; and we want to explore the possibility of adding other sections in this part to deal with the particularities of various types of asset – for instance land or particular categories of goods and intangibles (such as registered land, ships and aircraft and intellectual property).

This part also contains rules to deal with contractual restrictions on charging assets, which are broadly intended to reflect the current law. We considered whether it would be appropriate to tackle the problem of contractual restrictions on charging receivables. But, because it is currently the subject of proposals for change under the Small Business, Enterprise and Employment Act 2015, we decided not to do so. We have, however, included some suggested drafting on this issue as an Annexure to the User Guide. It enables a charge to be created even if there is a prohibition in the relevant contract, but makes it clear that this does not affect the rights of the counterparty to the contract. The chargee gets a proprietary interest which is effective in the chargor's insolvency – which should not concern the counterparty. But, where the counterparty is concerned – for instance whom to pay, how much and when – the existence of the charge does not affect the counterparty at all.

Part 4: Secured obligations

Secured obligations are drafted broadly:

(18) Secured obligations

18.1 The secured obligation can be any obligation or liability of any kind of any person. It can be an obligation to pay money, but it does not have to be. It can be present, future or contingent. It does not have to be owed by the chargor.

18.2 The identity and extent of the secured obligation depends on the objective intention of the chargor (see part 1).

18.3 The scope of the secured obligation must be capable of being identified when the charge comes to be enforced. It is not necessary to identify it at an earlier stage.

18.4 For example, a secured obligation may include a liability to pay all money from time to time owing:

(a) to a particular person or class of persons; or

(b) under a particular agreement or class of agreements

In practice, one of the most difficult issues concerning secured obligations is the extent to which a charge granted to secure a particular facility will extend to that facility as amended in a fundamental way. This is ultimately a matter of interpretation, but s 19 attempts to establish a broad default rule (which can be contracted out of) that the charge does extend even to fundamental amendments. This is intended to benefit chargors as much as chargees. In our experience, the wish to avoid more documentation comes from chargors – because they would generally have to pay for it.

The Code currently enables any liability to be secured. There is a question whether this should be limited to monetary liabilities – not just primary obligations to pay debts of all kinds (including future and contingent debts) but also secondary obligations to pay damages. The question is whether it is practicable to secure an obligation which is ultimately to do something other than to pay money. In such a case, it is not possible to establish the extent to which the secured assets are required in order to discharge the secured liability. This is one of the many issues which we would like to discuss in relation to the Code.

Part 5: The parties to a charge

The Code applies to all chargors, but part 5 limits the extent to which natural persons can create charges over their goods. The Law Commission is currently conducting a review of the Bills of Sale legislation, and this may therefore be overtaken by events. On the assumption that it is recognised that consumers should not be able to create security over absolutely all of their assets, the Code contains a suggested approach to charges over goods. Again, it is intended as a starting point for discussion.

Part 6: The terms of a charge

The underlying principle is freedom of contract:

(25) The principle

25.1 Subject to the provisions of this Code and of any other relevant laws and regulations (such as those concerning consumers), the terms of the charge can be agreed between the parties from time to time.

25.2 For instance, subject to those limitations, the parties can agree:

(a) the rights, powers, liberties and immunities of the parties before enforcement;

(b) the chargee's powers of enforcement; and

(c) the rights, powers, liberties and immunities of the parties on and after enforcement.

Section 27 preserves the concept of the equity of redemption, but does away with the doctrine of "clogs on the equity of redemption", which it was considered is an unnecessary extension which can create practical problems in commercial transactions.

Part 7: Registration

Part 7 is intended to reflect the current law of registration at Companies House, but extend it to statutory and charter companies, partnerships, limited partnerships and sole traders if it is thought commercially worthwhile to do so:

(28) The scope of this part

28.1 This part provides for the registration of certain charges (described as registrable charges) created by UK businesses. Such charges do not become effective until they are registered.

28.2 It also enables the registration of charges created by UK businesses which are not registrable charges, and also of receivables financing agreements entered into by UK businesses. Charges and agreements of this kind do not require registration to be effective, but they may be registered if the parties wish.

28.3 A UK business is any of the following:

(a) a UK-registered company within the meaning of section 1158 of the Companies Act 2006;

(b) a company incorporated by statute or created by Royal charter in any part of the United Kingdom;

(c) a limited liability partnership registered in any part of the United Kingdom;

(d) a partnership or limited partnership which is created under the law of any part of the United Kingdom;

(e) a resident natural person who is carrying on business as a sole trader.

28.4 The registrar is the Registrar of Companies.

(29) Registrable charges

29.1 Every charge created by a UK business is a registrable charge unless it is an exempt charge.

29.2 An exempt charge is:

(a) a possessory charge; or

(b) a financial collateral charge; or

(c) a rent deposit charge; or

(d) a Lloyd's charge; or

(e) a central bank charge; or

(f) a charge which is exempt from registration under this Code as a result of other legislation.

29.3 A charge is not created by a UK business if:

(a) the charge arises by operation of law; or

(b) the UK business acquires an asset which is already subject to the charge; or

(c) the UK business is the owner of property and, in connection with a dealing with that property, it retains an interest in the property to secure the payment of a secured obligation.

Exempt charges broadly reflect the current law, and include possessory charges – which would replace pledges.

It is generally accepted in the profession that the registration of charges is worthwhile and effective. The problem comes in trying to extend the current registration system from companies to individuals. The approach which has been adopted under the Personal Property Security Acts in other jurisdictions is that registration should apply to all chargors. This has an appealing logical simplicity, but it has meant the creation of new stand-alone registration systems which can be complicated and expensive to establish and maintain.

The current company registration system works well in practice, and the Code has been built around this.

The starting point of the Code is that registration of charges is important in commercial transactions, and that it should be required unless there is a very good reason not to have to register. But it accepts that what is required in a commercial context is not necessarily required outside it. A requirement for all individuals to register most charges they create is unlikely to be cost-effective. What is needed is to draw a line between commercial and consumer transactions; and to require registration only in relation to commercial transactions.

The simplest way to do that is to require registration by companies, and not by individuals (although charges created by individuals would continue to be registrable in the asset registries). The Code broadly follows this line, but adds certain other categories of person to a list of those who need to register. The Code would enable partnerships, limited partnerships and sole traders to register at Companies House if they want to create a charge. What needs to be considered is whether the benefits which would be obtained from registration justify

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the cost of requiring it. But one of the key points here is that this would be an extension of the existing system of registration, not the creation of a wholly new one.

The registration system which is described in part 7 is based on the current system of registration at Companies House, with suggested improvements and simplifications. In addition, s 37 enables (but does not require) the registration of receivables financing agreements, such as factoring and invoice discounting agreements. These are not treated in the same way as charges. Registration is not a requirement of validity. It would be a voluntary system of registration which could be used by receivables financiers in order to improve their priority position. This is an issue which has been discussed for some time. We would like to assess its practicality.

Part 8: Priorities

The current priority rules in England are intractable, and there is a general consensus that they should be simplified and improved. The problem is that this has to be done in relation to all types of interest in all types of property. A comprehensive reform of priority rules cannot be achieved within the context of a secured transactions code.

So what the Code tries to do is to deal with certain key priority issues which are relevant in relation to charges whilst, at the same time, allowing the existing rules to apply where the Code does not.

The Code regulates the priority of charges amongst themselves. The key principles are:

- Chargees should be able to regulate their priority by agreement.
- If a chargee takes a charge over an asset when it actually knows that it is already charged, the new charge will rank behind the earlier charge unless this is not permitted by a relevant asset registry.
- Where assets are registrable in an asset registry, the priority rules of the asset registry apply. This generally means that the first to register at the asset registry takes priority.
- Where the assets concerned constitute financial collateral, it may be necessary to have specific rules which reflect the expectations of those in the market.
- The default rule is that the priority of charges between themselves depends on the times they become effective (and a registrable charge only becomes effective on registration at Companies House).

Similar rules regulate the priority of receivables financing agreements.

Part 8 also deals with the circumstances in which an outright purchaser of an asset will take free of a charge. This will generally be a matter of the interpretation of the charge itself. It will specify the extent to which the chargor has the ability to sell assets free from the charge. In a properly drafted charge, this will normally be all that is required.

But there will inevitably be cases where a purchaser will need to buy an asset from a company without checking the terms of the charge. A company cannot sensibly carry on business if its purchasers are always required to check its charges register before doing business with it.

In dealing with this problem, the Code draws on the well-known distinction between fixed and current assets. A person should generally be able to buy a current asset from a company without checking what charges it has created. But, in the case of a fixed asset, the purchaser would be expected to check. The distinction is not always easy to draw, particularly because it depends so much on the business of the company concerned. But then it does reflect the realities of the commercial situation.

Part 9: Enforcement

In practice, most powers of enforcement are set out in the charge itself. The default powers of enforcement in legislation and case-law are complicated, confusing and out-of-date. The Code assumes that powers of enforcement will continue to be set out in the charge documents, but it establishes default powers which are more in line with current commercial practices.

This part also sets out the duties of those enforcing security, which are broadly intended to reflect the current position.

One issue for discussion is whether a system should be introduced to enable the chargee to retain the asset on enforcement if there are suitable protections for the chargor. Foreclosure is not available under the current law without a court order, although appropriation of financial collateral serves a similar purpose and does not require a court order. One question is whether it is possible to establish appropriate safeguards for the chargor to establish a general out-of-court procedure.

Part 10: Insolvency proceedings

It would be possible for the Code not to deal with insolvency proceedings at all. But, because security is rarely enforced outside an insolvency proceeding, it was thought important to refer to them.

The Code provides that the proprietary interest created by a charge remains effective in insolvency proceedings, but that the rights of the chargee are subject to the insolvency legislation (for instance, in relation to moratoria on administration and claw-back).

Insolvency law currently draws a distinction between fixed and floating charges. The Code does not draw this distinction. One issue for discussion is therefore what, if any, liabilities should rank ahead of charges on an insolvency. This is the subject of the second Discussion Paper issued by the CLLS in February 2014.

CONCLUSION

The purpose of issuing the Code is to start a debate on the desirability of codifying the law. We hope you will join the debate. If you would like to do so, please email Richard Calnan. ■

1 http://www.citysolicitors.org.uk/attachments/category/129/Secured%20Transactions%20Code%20-%20Discussion%20draft.pdf and http://www.citysolicitors.org.uk/attachments/category/129/Secured%20Transactions%20Code%20-%20User%20Guide.pdf

Further Reading:

- Secured Transactions Reform [2013] 1 JIBFL 6.
- Bills of Sale Acts: ripe for reform? [2013] 11 JIBFL 685.
- LexisNexis Loan Ranger blog: Secured Transactions Law Reform Project – Update.